

**NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	No. C9A970045
v.	:	
	:	
	:	Hearing Officer - DMF
	:	
	:	
Respondent.	:	

ORDER DENYING MOTION FOR ENTRY OF DEFAULT DECISION

The Department of Enforcement has moved for a Default Decision holding that respondent _____ violated NASD Rules 2110 and 2220(d)(1)(A) by sending communications to the representative of a customer that “contained intentional misleading misrepresentations and omissions,” as alleged in the Complaint and the Amended Complaint filed in this proceeding. Enforcement asks that _____ be fined “at least” \$5,000 and suspended in all capacities for “at least” three months. For the reasons set forth below, the motion will be denied, based on the existing record. Enforcement may submit additional support for a Default Decision within 30 days, after which a final Decision will be issued in this proceeding.

Standards for a Default Decision

The Default Decision process should not be unduly burdensome, but it must be meaningful. To justify a Default Decision, Enforcement must demonstrate that there is a reasonable basis for the Hearing Officer to find that the respondent has violated NASD Rules, as alleged in the Complaint. Enforcement must also show that the sanctions it seeks are appropriate under the facts and circumstances of this case.

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The Complaint itself may provide substantial support for a Default Decision. Rule 9212(a) requires that the Complaint “specify in reasonable detail the conduct alleged to constitute the violative activity and the rule, regulation, or statutory provision the Respondent is alleged to be violating or to have violated.” Rule 9215(f) provides that, if the respondent fails to file an Answer, the Hearing Officer, in the exercise of his or her discretion, may treat the allegations of the Complaint as admitted by the respondent. Thus, if Enforcement lays out its case in reasonable detail in the Complaint, those details may be deemed admitted, and may provide much of the basis for a Default Decision. On the other hand, otherwise unsupported conclusions in a Complaint do not, by themselves, justify a Default Decision.

Enforcement may also support a Default Decision with affidavits and exhibits that flesh out the allegations in the Complaint. Generally, however, unexplained evidentiary materials are inadequate. Except in relatively straightforward cases, where the legal and factual bases for the Default Decision are readily apparent, Enforcement must articulate a coherent and convincing “theory of the case,” which should explain the legal standards and provide a framework explaining why Enforcement believes the evidentiary materials adequately support the violation it has charged and the sanctions it seeks.

The Record in Support of Enforcement’s Motion for a Default Decision

1. The Complaint, Amended Complaint, and Attachments.

The Complaint in this case contains only a single substantive paragraph, alleging, in its entirety:

In October 1995, _____ sent to PS, an individual with trading authorization for the account of HAB, spreadsheets (attached as Exhibit 1) that purportedly reflected the extent of options trading that _____ had conducted in the account. The spreadsheets contained intentional material misrepresentations and omissions, in that they demonstrated that the options trading had generated a profit of about

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\$15,203.29, but omitted any reference to a total of six purchase transactions, and the losses generated by the two sales of the positions, about \$113,874.23, as of approximately October 10, 1995.

Enforcement later filed an Amended Complaint that corrected these allegations. As amended, the first sentence of this paragraph begins: “On or about August 30, 1995 and on or about October 14, 1995, _____ sent, respectively, two spreadsheets and one spreadsheet (three pages in total attached as Exhibit 1) to PS” The remainder of the paragraph is unchanged. Without further elaboration, both the Complaint and the Amended Complaint allege that “_____ conduct violated Conduct Rules 2110 and 2220(d)(1)(A).”¹

The attached spreadsheets are not dated, and do not state why or by whom they were prepared. At the top of each spreadsheet page is HAB’s name. Beneath the name are columns of information under the headings: Purchase Date; Option; Sale Date; Symbol; Quantity; Cost; Proceeds; and Net. The information in the columns is typewritten, but beneath the columns on each page are handwritten figures that appear to reflect accurately the aggregate total of the individual figures listed in the “Net” column on the page. At the bottom of the third spreadsheet page, handwritten, appears: “Total through 10/9 15,203.29.” This appears to reflect accurately the aggregate total of the individual figures listed in the “Net” columns on all three pages. The spreadsheets do not indicate who wrote the handwritten figures.

Neither the Complaint nor the spreadsheets include any information about HAB or PS; any explanation of the purpose of the account or the circumstances under which it was opened; any description of _____ authority over the account; or any detail concerning the circumstances surrounding the preparation, transmission, and receipt of the spreadsheets. They set forth no

¹ Compl. ¶¶ 3-4; Amended Compl. ¶¶ 3-4.

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facts to substantiate the Complaint's allegation that the spreadsheets "purportedly reflected the extent of options trading that _____ had conducted in the account"; do not specifically identify the transactions allegedly omitted from the spreadsheets; and offer no facts, other than those quoted above, to support the Complaint's allegation that _____ intentionally omitted these transactions from the spreadsheets.

If Enforcement had included additional details in the Complaint, the Hearing Officer might have deemed them admitted under Rule 9215(f), and those admissions might have provided substantial support for Enforcement's motion. In addition, a more detailed Complaint could have provided a framework for understanding the materials submitted by Enforcement in support of its motion for a Default Decision.

2. Enforcement's Submission in Support of its Motion for a Default Decision.

In support of the motion, Enforcement submitted the Declaration of _____ and 16 Exhibits (CX 1-16). The Declaration contains no additional factual support for the charges. Neither the motion nor the Declaration offers any analysis of the applicable legal standards, or explains in any detail why Enforcement believes the Exhibits support the charges in the Complaint or the sanctions Enforcement seeks.

This is not a case in which the legal and factual bases for the Complaint are readily apparent from the Exhibits. The Complaint charges that _____ violated Rules 2110 and 2220(d)(1)(A). Rule 2220 concerns "Options communications with the Public." Rule 2220(d)(1)(A) provides in relevant part: "No ... person associated with a member shall utilize any ...communications to any customer or member of the public concerning options which ... contains any untrue statement or omission of a material fact or is otherwise false or misleading" The element of intent is not stated in the Rule, but is alleged in the Complaint.

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Only 10 of the Exhibits, CX 7-16, relate to the substantive allegations of the Complaint. CX 7 is a two-page letter to the NASD from _____, _____ former employer, describing conclusions the firm reached as a result of an internal investigation that led the firm to terminate _____. The letter refers to numerous attachments to support and explain those conclusions, but the attachments are omitted from CX 7.² Many of the firm's conclusions seem clearly to concern alleged misconduct by _____ that is not charged in this proceeding. Other conclusions might relate to the charges in this proceeding, but, because the Exhibit omits the attachments, it is difficult to interpret or evaluate those conclusions.

CX 8 is a copy of the document authorizing PS to trade for HAB's account. It offers no additional support for or explanation of the charges in the Complaint. CX 9 consists of two letters from PS to the NASD. These are the only customer statements in the record. The relevant portions of the first letter are four numbered paragraphs, each one sentence long. The relevant portion of the second letter is a single sentence. The letters state that PS received the first two spreadsheet pages from _____ on or about August 31, 1995, and the third spreadsheet page from _____ on or about October 15, 1995, as alleged in the Amended Complaint. PS also states that _____ gave him two hand written sheets of paper at a meeting in November 1995. This may refer to CX 12 (which consists of two hand written sheets), but there is nothing to confirm this. Finally, PS denies _____ statement in CX 16 (discussed below) that _____ gave PS an additional spreadsheet page that included "open" option positions in the account.

The letters contained in CX 9 are very brief and are notable for what they do not include. They do not include any information about the purpose of the account; the relationship between

² Some of the other Exhibits submitted by Enforcement in support of the motion may, in fact, have been among the attachments to CX 7, but they are not identified as such.

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_____ and PS or HAB; the circumstances surrounding the preparation, transmission and receipt of the spreadsheets; or the transactions omitted from the spreadsheets. They do not address whether _____ represented that the spreadsheets “reflected the extent of options trading that _____ had conducted in the account,” as alleged in the Complaint, or whether PS understood them to include that information. In fact, PS does not say that he found the spreadsheets misleading in any respect.

CX 10 consists of the monthly statements for HAB’s account prepared by _____. The transactions allegedly omitted from the spreadsheets are not specifically highlighted or otherwise identified. CX 11 is a two-page spreadsheet bearing the caption “Account Analysis: [HAB].” It appears to have been prepared by someone at NASD during the investigation to show all of the activity in HAB’s account. CX 11 does not highlight or otherwise identify the transactions allegedly omitted from the spreadsheets attached to the Complaint. CX 12 is a handwritten spreadsheet which appears to contain information regarding transactions in HAB’s account, but it does not, on its face, explain when, by whom, or for what purpose it was prepared.

CX 13 is a one page document dated January 4, 1996, that appears to summarize a termination meeting between _____ and management at _____. The meeting seems to have focused on alleged misconduct by _____ that is not charged in the Complaint. CX 14 is a series of letters from _____ to PS in December 1995. The letters seem to have been the primary topic of the termination meeting summarized in CX 13, but they are not cited in the Complaint.

CX 15 includes a letter from the NASD to _____ and his response, dated May 15, 1996. The NASD’s letter asked _____ to address several customer complaints listed on the Form U-5 Termination Notice filed by _____, including a complaint from PS and HAB,

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but the NASD's letter does not disclose the substance of those complaints. _____ response includes statements about the circumstances under which HAB opened the account, the purpose of the account, and the nature of the transactions in the account. The statements are generally self-serving, and do not seem to offer any support for the Complaint. Neither the NASD's letter nor _____ response refers to the spreadsheets attached to the Complaint.

CX 16 consists of a letter from the NASD to _____ and his response, dated July 31, 1996. The NASD's letter asks _____ to respond to questions contained in six numbered paragraphs. Most of these questions refer _____ to documents that were attached to the letter, but those attachments are omitted from CX 16. As a result, it is difficult to interpret both the NASD's questions and _____ responses. It appears, however, that only Paragraph 5 of the NASD's letter could refer to the spreadsheets attached to the Complaint. Paragraph 5 reads:

Concerning attached exhibit #5, _____ states that, without prior supervisory approval, you provided the customer with these schedules and that these schedules contain false and misleading information concerning losses in the account. You are hereby required to provide a complete and detailed written explanation of the reason you provided the customer with false and misleading information.

_____ response to this paragraph was as follows:

Regarding item five, exhibit #5. As a matter of routine practice, brokers in the office sent spread sheets of account activity to clients. Individual written statements concerning monthly dividends and interest payments were also prepared by the sales support staff on a routine basis and mailed to clients along with monthly checks. To my knowledge none of these documents received supervisory approval before being mailed to the customers.

The three pages making up exhibit #5 do not represent all of the spread sheet data prepared for the client. I distinctly remember hand delivering to the customer a page (not included in your exhibit #5) with the hand written notation "open," indicating option positions not closed out. Several of these transactions are in your exhibit #1.

* * *

My intent to have these spreadsheets produced was to assist the customer in the identification of trades with the billing documents being generated by _____.

PS, however, states, “At no time did _____ ever send to me any sheets showing outstanding options.”³

3. Oral Argument on the Motion.

Faced with the challenge of evaluating whether and how these materials support the charges in the Complaint and the sanctions requested by Enforcement, the Hearing Officer held a Pre-Hearing Conference at which Enforcement was offered an opportunity to present oral argument in support of its motion. During the argument, Enforcement clarified the record in some important respects. For example, Enforcement identified the transactions it alleges _____ intentionally omitted from the spreadsheets. Those transactions include six purchases of options on August 14, 15, 25 (2 purchases) and 31, and September 5, 1995, and two sales closing out those positions on September 14, 1995. Enforcement showed where those transactions appear on CX 10, 11, and 12.

Enforcement explained that it does not contend the transactions were unauthorized, stating that “this case has to be considered on the assumption that all transactions were discussed beforehand.”⁴ Enforcement also acknowledged that all of the transactions in the account, including those omitted from the spreadsheets, were accurately shown on the account statements contained in CX 10, and that the omitted transactions were included in account statements sent to the customer before PS received the third spreadsheet page. Enforcement speculated that it

³ CX 9.

⁴ Tr. 12.

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might be difficult for a customer to match up purchases and sales, based on the statements alone, in order to determine the net gain or loss on particular transactions, but pointed to no evidence regarding PS's understanding of the transactions, the account statements, or the spreadsheets.

The Enforcement attorney explained that he had been assigned to this case when the Complaint was filed, and so had limited knowledge of the underlying facts. As a result, Enforcement could not identify who at the NASD prepared CX 11, could offer only an assumption that CX 12 was prepared by _____, and could not identify who wrote the handwritten figures on the spreadsheets attached to the Complaint. When asked what evidence supported the Complaint's allegation that the spreadsheets "purportedly reflected the extent of options trading that _____ had conducted in the account," as alleged in the Complaint, Enforcement stated: "I honestly don't know what I could point to to support that particular clause." Enforcement argued that the representation might be inferred from the appearance of the spreadsheets themselves, but could not confirm that the transactions cited as a basis for the Complaint were the only transactions omitted from the spreadsheets.⁵

As support for the Complaint's allegation that the omissions were "intentional material misrepresentations and omissions" to cover up losses in the account, Enforcement pointed to correspondence from _____ to PS contained in CX 14. Enforcement argued that those letters contained false or misleading statements as part of a "continuing course of conduct," and that it may be inferred _____ intentionally omitted transactions from the spreadsheets as part of the overall scheme.⁶

⁵ Tr. 29-30.

⁶ Tr. 41-42.

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The letters are dated in December 1995, months after the Complaint alleges _____ sent the misleading spreadsheets, and do not refer to the spreadsheets. They refer to six transactions in HAB's account, but only one of those transactions was among the transactions that Enforcement alleges _____ omitted from the spreadsheets. Therefore, even assuming that the letters contained false or misleading statements, on the existing, very limited record, the Hearing Officer cannot conclude that they were part of a "continuing course of conduct," or that they offer significant support for the allegations in the Complaint.

Discussion

Based on the existing record, Enforcement has not shown a reasonable basis for the Hearing Officer to find that _____ violated Rules 2220(d)(1)(A) and 2110 as alleged in the Complaint, or a reasonable basis for the Hearing Officer to determine what sanctions would be appropriate if the violations were shown. The Complaint sets forth Enforcement's claim in broad, conclusory fashion. Enforcement's apparent theory that _____ intended to mislead PS by omitting from the spreadsheets certain transactions that led to losses may be plausible, but Enforcement has not supported the theory with a detailed, persuasive legal and factual analysis.

For example, one of the Complaint's key conclusory allegations is that the spreadsheets "purportedly reflected the extent of options trading that _____ had conducted in the account." Enforcement has not shown that _____ expressly represented to PS that the spreadsheets contained information on all of the options trading in HAB's account, or that _____ transmitted the spreadsheets to PS under circumstances implying such a representation, or even that PS interpreted the spreadsheets as showing all options trading in the account. Enforcement argues that the representation is implied on the face of the spreadsheets, but has failed to articulate any

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coherent explanation why it believes that is so. Enforcement must provide either more evidence to support the conclusory allegation in the Complaint, or a better explanation of how the existing record supports that conclusion.

Similarly, Enforcement has not offered adequate support for its allegation that _____ employed “intentional material misrepresentations and omissions” to cover up large losses in the account. This allegation rests implicitly on the assumption that PS was not otherwise aware of those losses, but Enforcement has not shown why that would have been the case. The record suggests that HAB “is a sophisticated investor” who gave PS trading authorization for the account.⁷ Enforcement has conceded that _____ and PS discussed all of the transactions before they were executed. Normally, one would expect that, in the course of authorizing a sale to close out an open options position, a sophisticated customer would ask about the net gain or loss on the transaction. Perhaps PS did not ask for that information, or perhaps he did ask and _____ lied. The point is that, given Enforcement’s assumption that PS and _____ discussed each transaction in advance, it is difficult simply to assume, even in the context of a Default Decision, that PS was unaware of the losses.

The record also suggests that PS had other independent evidence of the losses. Enforcement concedes that the all of the transactions (and therefore their net impact on the account) were reflected in the monthly account statements. Enforcement hypothesizes that PS might not have been able to match up the purchases and sales on the statements, in order to determine the net gain or loss on the purchase and sale of particular positions. But even if that were the case, it would not explain how PS could possibly have been oblivious to an overall net loss of more than \$113,000 on those transactions that would have been reflected in the account

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balances shown on the monthly statements. Once again, to justify a Default Decision, Enforcement must provide either additional evidence or explain more clearly how the existing evidence supports the conclusions alleged in the Complaint.

Finally, given the nature and complexity of this proceeding, Enforcement should provide a clearer recommendation on sanctions, based on an analysis of the relevant factors under the Sanctions Guidelines. Those factors include not only the ones listed under the specific Sanction Guideline applicable to this proceeding, which appears to be “Misrepresentations or Material Omissions of Fact,” but also the more general “Principal Considerations in Determining Sanctions” listed in the Sanctions Guidelines that are relevant under the specific facts and circumstances of this case.

Therefore, it is ORDERED that Enforcement’s motion for a Default Decision is denied, based upon the existing record. Enforcement may submit additional support for a Default Decision within 30 days, including additional evidence or a more thorough analysis of the existing record, after which a final Decision will be issued in this proceeding.

David M. FitzGerald
Hearing Officer

Dated: Washington, DC
September 16, 1998

⁷ CX 7, p. 1.